

# SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Corbett Analyst: Marion Mann DeJong Bill Number: AB 2xx

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 9/4, 9/6, & 9/12/01

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Excess Gross Receipts from Electrical Energy Distribution Tax/California Electrical Generator Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

X FURTHER AMENDMENTS NECESSARY.

X DEPARTMENT POSITION CHANGED TO Oppose, unless amended.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED May 15, 2001, STILL APPLIES.

OTHER - See comments below.

## SUMMARY

This bill would:

- impose a tax on excess gross receipts from electrical energy distribution (excess tax),
- require purchasers of electricity to withhold and remit 100% of the excess tax,
- allow an income tax credit for taxes similar to the excess tax paid to another state,
- create an annual sales tax holiday for certain property, and
- allow an income tax credit for new electrical power generation facilities.

## SUMMARY OF AMENDMENTS

The September 4, 2001, amendments made the following changes:

- added the provisions relating to the sales tax holiday,
- added the provisions relating to the income tax credit for power generation facilities,
- changed the rate of the excess tax to marginal rate,
- modified the due date for remitting the excess tax and filing returns for calendar quarters ending prior to the date the bill is enacted,
- deleted the provision allowing the California Public Utilities Commission (CalPUC) to authorize exemptions from the excess tax and replaced it with exemptions for qualifying facilities as defined,
- defined "binding written contract," and
- made other minor technical changes.

Board Position:

<u>      </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> X OUA	<u>      </u> PENDING

Legislative Director

Date

Brian Putler

12/05/01

The September 6, 2001, amendments made the following changes:

- Specified that the sales tax holiday would be allowed for the 2001 calendar year, and that for each calendar year from 2002 to 2005, the exemption would be allowed only if certain qualifications are met.
- Modified the definition of “qualifying facilities” that are exempt from the excess tax.

The September 12, 2001, amendments added an exemption from the excess tax for sales of electricity made by certain publicly owned electric utilities.

These amendments resolved some of the department’s implementation concerns, all the technical concerns, and raised new concerns. The “Purpose of the Bill,” “Background,” “Federal/State Law,” “Legislative History,” and “Other States’ Information” discussions from the department’s analysis of the bill as introduced May 15, 2001, still apply. The “Position” has been changed to reflect Board action taken in June. The remainder of the department’s prior analyses has been updated to reflect the recent amendments and is provided below.

## **EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that the excess tax would be operative for each calendar quarter beginning on or after January 1, 2001, and before January 1, 2006. The withholding provisions would be operative for the first calendar quarter beginning after the bill becomes effective.

## **POSITION**

Oppose, unless amended.

At its June 27, 2001, meeting, the Franchise Tax Board voted 2-0 to oppose the June 12, 2001, version of this bill unless amended to resolve department concerns. Annette Porini, on behalf of Member B. Timothy Gage, abstained from voting.

## **Summary of Suggested Amendments**

Amendments are needed to resolve implementation concerns. See “Implementation Considerations” below. Department staff is available to assist the author with amendments.

## **ANALYSIS**

### **THIS BILL**

#### **Excess Tax**

This bill would impose an excess tax on certain sellers of electricity in California. The sellers of electricity must have nexus in California and make the first sale of electrical power for consumption in California. The tax rate would be determined by the amount that the sales price per mWh of electricity exceeds the base price, as follows:

- 50% of the amount that exceeds the base price, but not more than 150% of the base price, plus
- 70% of the amount that exceeds 150% of the base price, but not more than 200% of the base price, plus
- 90% of the amount that exceeds 200% of the base price.

“Base price” would mean \$60 per mWh of electricity sold, or any subsequent price set by the CalPUC. Beginning with the first calendar quarter following the effective date of this bill, the CalPUC would revise the base price. The revised base price would apply to the succeeding calendar quarter. The CalPUC must publish the base price by the first day of the last month of each calendar quarter. For example, if the bill became effective September 30, 2001, the CalPUC would be required to publish the revised base price by December 1, 2001. The revised base price would apply to the calendar quarter beginning January 1, 2002, and ending March 31, 2002.

“Sellers of electricity” would mean a person or any other entity, that is a producer, generator, wholesaler, retailer, marketer, or other vendor of electricity sold for consumption in this state.

“Sold for consumption in this state” would mean any of the following:

- sales of electricity made directly to a purchaser in this state for that purchaser’s consumption in this state.
- sales of electricity to a retailer of electricity for resale to a purchaser in this state for that purchaser’s consumption in this state.
- sales of electricity to the State of California, to any agency of the state, or to the California Independent Systems Operator (ISO).

“Nexus” would be established if the seller of electricity meets any of the following conditions, which exceed a de minimis level of contact:

- Has a physical presence in California through the presence of one or more employees, agents, members of a commonly controlled group, or representatives or other persons acting on the seller’s behalf, whether or not characterized as an independent contractor.
- Owns, leases, or rents real or tangible property in California.
- Maintains a contractual relationship with persons in California relating to the sale, distribution, or transmission of electricity to purchasers within California.
- Regularly or systematically solicits a market for the sale or purchase of electricity for the ultimate consumption in California or otherwise purposefully avails itself of California’s electricity market.

- Directly or indirectly delivers or causes delivery of electricity to any portion of the electrical grid located within California or otherwise uses that electrical grid.
- Is a member of a unitary group for which at least one member is required to file a combined report or would be required to file if a water's-edge election were not in place.
- Conducts any other activity that is not otherwise protected under the U.S. or California Constitutions, or federal or California laws.

"Electrical grid" would mean the system of interconnected generators and power lines managed in order to dispatch generators as needed to meet the requirements of the customers connected to the grid.

The excess tax would not apply to sales of electricity for consumption in California made;

- pursuant to a "binding written contract," as defined, executed on or before the effective date of the bill,
- pursuant to a "qualified contract," as defined, executed after the effective date of the bill,
- by "qualifying facilities," as defined, or
- by a California-based local publicly owned electric utility, provided its governing board determines the sales price to be just and reasonable.

A seller is required to remit 100% of the excess tax to FTB by the 15<sup>th</sup> day of the month immediately following the end of a calendar quarter. Interest would be assessed on amounts not remitted by the due date. The seller would also be required to file a quarterly return to FTB by the 15<sup>th</sup> day of the month immediately following the end of a calendar quarter.

For calendar quarters beginning on or after January 1, 2001, and before the date this bill becomes effective, the tax and the return are due no later than the 15<sup>th</sup> day of the second month of the first calendar quarter beginning after the bill becomes effective. For example, if the bill were enacted on September 30, 2001, the tax and returns would be due November 15, 2001.

Since electricity is fungible, the bill would provide a method for sellers to determine the amount of electricity sold to a retailer that also generates its own electricity for retail. "Sales of electricity to a retailer of electricity for resale to a purchaser in this state" would be determined by multiplying the total sales, based on mWh, made to a retailer during the calendar quarter by the greater of the following two ratios:

1. The ratio of retailer's total sales of electricity made directly to purchasers in California during the 2000 calendar year to the retailer's total sales of electricity everywhere during the 2000 calendar year. If the retailer had no sales history during the 2000 calendar year, the ratio would be zero.
2. The ratio of retailer's total sales of electricity made directly to a purchaser in California for that purchaser's consumption in California during the calendar quarter to the retailer's total sales of electricity everywhere during the calendar quarter.

Retailers would be required to provide sellers and FTB with the information needed to determine these ratios. If the information needed to determine these ratios were not available, the seller would make a tentative payment based upon the last available information. Once the retailer's information is available, the difference between the tentative payment and the tax due should be remitted to FTB no later than the 15<sup>th</sup> day of the first month following the calendar quarter in which the information becomes available.

Except for residential customers and small businesses, all purchasers of electricity for consumption in California would be required to withhold 100% of the excess tax from payments made to sellers. The tax would be remitted to FTB by the 15<sup>th</sup> day of the month immediately following the end of the calendar quarter for which the tax was withheld. Every purchaser required to withhold would be liable as a withholding agent for the tax.

Interest for failure to pay tax by the due date would be assessed on the taxpayer. The taxpayer is authorized to seek reimbursement for interest paid from the withholding agent obligated to remit the withheld tax. In addition, the withholding agent would be required to file a quarterly statement to FTB showing:

- the seller's name,
- the seller's tax identification number,
- the amount of tax withheld,
- the total number and amount of mWh of electricity purchased,
- the sales price of the electricity purchased,
- the purchaser of the electricity, and
- other information FTB deems necessary.

FTB would be required to inform each seller of electricity for which the excess tax was withheld and remitted to FTB by a purchaser of (1) the amount withheld and remitted, and (2) information related to the ratios for retailers if applicable.

The amount withheld and remitted would be presumed to be the excess tax owed, unless the seller requests a refund. The seller would be required to explain the reasons and facts that demonstrate why the tax withheld and remitted did not accurately reflect the tax owed.

The base price set by the CalPUC would be presumed to represent a fair sales price reflecting the seller's cost of selling electricity plus a reasonable allowance for profit margins and maintenance and operational expenses. The seller could dispute the base price by filing a claim for refund with FTB. The claim must provide the reasons and calculations that demonstrate that the base price does not reflect the taxpayer's actual costs of selling electricity or provide for reasonable profit margins and maintenance and operational expenses.

The seller could also file a claim to dispute the ratios used to determine the amount of electricity sold to a retailer that also generates its own electricity for retail.

The CalPUC would be required to review any claim for refund and make recommendations to FTB regarding disposition of the claim. Claims for refund would be required to be filed within four years from the date the tax was required to be remitted or within one year from the date the tax was remitted, whichever period is longer.

Corporations required to pay the excess tax would be able to claim a deduction for that tax on their corporate franchise or income tax return.

### **Credit for Gross Receipts Tax Paid to Other States**

This bill would allow a credit equal to the amount of excess gross receipts taxes legally imposed and paid to another state or political subdivision with respect to the sale of electricity for consumption in California. The amount of the credit could not exceed the taxpayer's California excess tax liability. If the credit were less than the amount of excess tax due, the seller would be liable for the remaining amount of excess tax. It is department staff's understanding that currently no state imposes an excess gross receipts tax on the sale of electricity. Thus, this credit would be available only if another state enacted an excess gross receipts tax.

### **Sales Tax Holiday**

This bill would create an annual sales tax holiday for the first weekend in December by exempting the state portion of the sales and use tax for "qualified retail sales" as defined. The sales tax holiday would be allowed for the 2001 calendar year. For each calendar year from 2002 to 2005, the holiday would be allowed only if the Board of Equalization (BOE) determines by August 15 of the calendar year that the expected revenue loss of the exemption is equal to or in excess of<sup>1</sup> FTB's estimate of the annual receipts from the excess tax. BOE would be required to issue a statement notifying the public of the tax holiday on or before September 15 of the calendar year. BOE would be required to report the actual revenue loss from the sales tax holiday to the Legislature, Director of Finance, and FTB by April 30 of the following calendar year.

If the expected revenue loss of the sales tax holiday is less than FTB's estimate of the annual receipts from the excess tax, then an income tax credit for new electrical power generation facilities is allowed.<sup>2</sup>

To facilitate BOE's determination of whether a tax holiday would occur, FTB would be required to calculate and report to BOE the amount of excess tax collected during the first two quarters of the calendar year and the total amount projected to be collected for the calendar year on or before August 15 of the calendar year.

### **New Electrical Power Generation Facility Credit**

This bill would create an income tax credit for taxpayers that bring new electrical power generation facilities online during the year. "New electrical power generation facilities" would be defined as any facility that is powered by sources other than diesel fuel and that has not produced electrical power within 10 years prior to the date it was brought on line.

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<sup>1</sup>According to the author's office, this should be "equal to or less than." The author intends to allow the sales tax holiday only if the projected revenue loss from the tax holiday is less than the projected revenue gain from the excess tax.

<sup>2</sup>According to the author's office, the income tax credits would be allowed (1) after the sales tax holiday is allowed, or (2) instead of the sales tax holiday if the projected revenue loss from the tax holiday is in excess of the projected revenue gain from the excess tax.

The credit would be allowed if either of the following occurs:

1. The actual amount of excess tax for the taxable year exceeds the actual revenue loss resulting from the sales tax holiday.
2. The BOE determines that the expected revenue loss of the sales tax holiday is less than FTB's estimate of the annual receipts from the excess tax for the taxable year.

If the first condition is met, the total credit available is the excess tax minus the actual revenue loss resulting from the sales tax holiday. That amount is divided by the total mWh of electrical generation capacity of all new electrical power generation facilities brought online during the taxable year.

For example, if the excess tax due and payable for the taxable year is \$100, the actual revenue loss resulting from the sales tax holiday is \$75, and the total electrical generation capacity is 5 mWh, the total credit amount available to taxpayers per mWh is \$5  $(\$100 - \$75)/5 \text{ mWh} = \$5 \text{ per mWh}$ . A taxpayer with a new facility with a 2-mWh capacity would receive a credit of \$10  $(\$5 \text{ per mWh} \times 2 \text{ mWh} = \$10)$ .

If the second condition is met, the total credit available is the excess tax divided by the total mWh of electrical generation capacity of all new electrical power generation facilities brought online during the taxable year.

For example, if the excess tax due and payable for the taxable year is \$100 and the total electrical generation capacity is 5 mWh, the total credit amount available to taxpayers per mWh is \$20  $(\$100/5 \text{ mWh})$ . A taxpayer with a new facility with a 2-mWh capacity would receive a credit of \$40  $(\$20 \text{ per mWh} \times 2 \text{ mWh})$ .

Taxpayers would apply to FTB for the credit. FTB would be required to determine whether the taxpayer is eligible for the credit and provide written notification regarding eligibility for the credit to the taxpayer that applies for the credit.

Credits not used by the taxpayer during the taxable year could be carried forward for 16 years.

## IMPLEMENTATION CONSIDERATIONS

### **Excess Tax**

Since the tax amount would be withheld and remitted quarterly to the department, the excess tax would be administered outside current income tax forms and processes. The department would need to develop new forms, programs, and operations to administer this new tax. Department staff is reviewing the bill and developing a strategy for implementation. However, withholding of taxes is currently a program administered by the Employment Development Department. EDD has ongoing business constituents that comply with employee tax withholding requirements. That department may be able to implement the provisions of this new withholding program quickly.

The following implementation concerns relating to the excess tax have been identified with this bill. Department staff is available to assist with any amendments to resolve these concerns.

- Sellers would be required to remit the excess tax for calendar quarters beginning before the bill becomes effective by the 15<sup>th</sup> day of the second month of the first calendar quarter beginning after the bill becomes effective. This deadline could require returns to be filed within 45 days of the enactment date. Department staff is concerned that forms and processes could not be developed in time to process the remittance of the excess tax. Further, it may be difficult to provide withholding agents with appropriate instructions for withholding and remitting the tax before the withholding amounts are due.
- The excess tax is imposed on gross receipts from selling electrical power that is consumed in California. Once electricity is put onto the transmission grid it may be difficult to determine where a particular watt is actually used and whether the excess tax applies. It may be difficult for taxpayers, withholding agents, and department staff to determine if a sale is for electricity consumed in California. This could result in disputes between taxpayers and the department.
- The requirement that the seller and withholding agent remit tax at the same time is problematic. Although the seller can reduce the amount they are required to remit by any amounts withheld, sellers may not know what amounts have been withheld, and may overpay the tax. FTB is required to inform sellers of amounts withheld and remitted by withholding agents. However, this information could not be sent to the seller prior to the due date since the withholding agent has the same deadline to remit the tax.
- Department staff would not know when a sale occurred to enforce withholding or collection of the tax.
- The bill requires the tax to be remitted by the 15<sup>th</sup> day of the month immediately following the calendar quarter in which the sale occurs. The bill does not specify how to treat long-term contracts where a sale occurs but payment is made over a period of time. As drafted, it appears that the tax would be imposed regardless of when payment is received.
- The bill would provide a credit for excess gross receipts taxes paid to other states with respect to the sale of electricity for consumption in this state. However, it is unclear what would constitute an "excess gross receipts tax" for purposes of the credit and whether the tax must be described as being "for consumption," in the same manner as the tax to be added by this bill. For example, if Oregon imposes a tax on generation based on the difference between a sales price and some base price amount, would the credit be denied because the Oregon tax wasn't an excess gross receipts tax and wasn't described as imposed on "consumption?" Further, since the bill states the tax must be for the "sale of electricity for consumption in this state," it appears that the tax imposed by the other state must be on sales of electricity for consumption in California to qualify for the credit.



## **Sales Tax Holiday**

The department could not provide BOE with the excess tax revenue projections. Accurately forecasting the excess tax revenues is an essential component of the sales tax holiday and the income tax credits. Unfortunately, it is not possible for FTB to produce reliable revenue projections for the excess tax due to the inherent volatility of market conditions and the unpredictable nature of future base price changes. Without accurate forecasts of the excess tax and the revenue loss resulting from the sales tax holiday, this provision of the bill could not be implemented.

Further, the bill as currently drafted does not accomplish the author's intent. According to the author's staff, the sales tax holiday would be allowed only if the projected revenue loss from the tax holiday is less than the projected revenue gain from the excess tax. Amendments will be needed to accomplish the author's goals.

## **New Electrical Power Generation Facility Credit**

This provision of the bill cannot be administered as the author intended. According to the author's staff, the income tax credits would be allowed (1) after the sales tax holiday is allowed, or (2) in lieu of the sales tax holiday if the projected revenue loss from the tax holiday is in excess of the projected revenue gain from the excess tax. According to the author's staff, the total credit available in any year would be reduced by any revenue loss resulting from sales tax holiday. As currently drafted, the bill does not accomplish the author's goals and substantial amendments will be necessary. Since the author's staff has indicated that the bill will be amended before it continues to move through the legislative process, additional analysis of how the tax credit would be administered will be provided when the bill is amended.

This bill would require FTB to determine whether a taxpayer is bringing a new electrical power generation facility on line during the taxable year. Department staff does not possess the expertise necessary to make such determinations. The author might consider amending the bill to have the CPUC determine if a taxpayer is qualified for the credit.

## **TECHNICAL CONSIDERATIONS**

The following technical concerns have been identified. Department staff is available to assist the author with amendments to resolve these concerns.

- It appears that the text on page 4, lines 30 through 36 is not needed. Most of the text is repeated in the next paragraph. The bill should be amended to remove the excess language.
- On page 4, line 37: paragraph (2) should be replaced with paragraph (3). On page 4, line 38, and on page 5, line 8, the references to paragraph (1) should be changed to paragraph (2). It appears that these errors were made when a new paragraph (1) was added at page 4, line 15.
- Generally when referring to a credit that is allowed both under the Personal Income Tax Law and the Bank and Corporation Tax Law, "or" is used instead of "and" since a taxpayer would qualify for one or the other credit. Thus, "and" should be replaced with "or" on page 6, lines 7, 13, and 19, on page 7, lines 2, 4, and 16, page 8, lines 4, 10, 16, and 39 and page 9, line 2.

- On page 6, line 29 and page 8, line 26, “this” should be replaced with “that” since the code section being referenced is in another code.

## **FISCAL IMPACT**

The department's costs to administer this bill cannot be determined until the implementation concerns discussed in this analysis have been resolved. However, department staff anticipates that a supplemental appropriation for FTB's fiscal year 2001-02 budget would be needed to administer this bill.

## **ECONOMIC IMPACT**

If the bill were amended as indicated by the author's staff, any revenue attributable to the excess tax would be offset by equal amounts of revenue losses resulting from the sales tax holiday and the income tax credits distributed to taxpayers who bring a new electrical power generation facility online. Thus, there would be no revenue impact. In terms of cash flow timing between fiscal years, revenues collected would precede disbursements.

## **LEGAL IMPACT**

Some sellers of electricity that have profited from the California energy crisis may not be impacted by the excess tax because they may not have sufficient nexus in California. Companies that would be subject to the excess tax proposed by this bill may challenge the constitutionality of the nexus provisions contained in this bill. They may further challenge the constitutionality of the exemption provision for qualified contracts between sellers and the State of California on the basis of equal protection. It is unknown whether the tax would withstand such constitutional challenges. Further, providing an exemption from the tax for certain California-based local publicly owned electric utilities adds more uncertainty regarding a constitutional challenge.

The excess tax could be considered a form of indirect price regulation. Electricity price regulation is within the jurisdiction of the Federal Energy Regulatory Commission. As a result, this tax could be viewed as preempted by federal laws or regulations, and thus unconstitutional. However, since the tax rate is less than 100%, there is less likelihood that the tax would be seen as a regulatory act, because it would not effectively place a “price cap” on the cost of electricity sold.

The excess tax could be construed to be a net income tax. If it is found to be a tax on net income and if electricity is considered to be tangible personal property, the imposition of the excess tax might be subject to P.L. 86-272. In that case, some sellers of electricity might be immune from tax.

## **ARGUMENTS/POLICY CONCERNS**

This bill could be viewed as inequitable as it would impose an additional tax on a single industry that already is subject to state taxation to the extent of any income derived from California sources. On the other hand, this industry has been perceived as excessively driving up the cost of electricity for an excessive profit.

Because of the exemption from the excess tax for “qualified contracts,” contracts for the same period and the same price could be taxed differently when the buyer is a municipal utility district or electricity company instead of the State of California.

With the credit for gross receipts tax paid to other states, California will always yield its right to tax to another state that has a similar tax, even though the electrical energy is in fact consumed in California. The credit is apparently designed to avoid double taxation on essentially the same transaction. It could be argued that given that California consumers are actually paying the high price for electricity if a credit to prevent double taxation is to be allowed, the state of generation should provide that credit, because consumers in the state of generation are not harmed by the excess prices. Alternatively, the potential tax revenue from the sale transaction could be equally divided between the state of consumption and the state of generation.

### **LEGISLATIVE STAFF CONTACT**

Marion Mann DeJong  
Franchise Tax Board  
845-6979

Brian Putler  
Franchise Tax Board  
845-6333